GENERAL INDEX

NOTE.—The principal argument is in No. 420.

No. 337. THE UNITED STATES, APPELLANT, v. P. CHAUNCEY ANDERSON ET AL.

INDEX

CASE CITED

STATUTE

In the Supreme Court of the United States

OCTOBER TERM, 1925

No. 337

THE UNITED STATES, APPELLANT

v.

P. CHAUNCEY ANDERSON ET AL.

APPEAL FROM THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

OPINION IN THE COURT BELOW

The opinion of the Court of Claims is not yet reported. It is in the record at page 17.

GROUNDS OF JURISDICTION

The judgment to be reviewed was entered in the Court of Claims January 5, 1925. (R. 19.)

Appeal was allowed March 16, 1925 (R. 19), under Sections 242 and 243, Judicial Code.

STATEMENT

This case is similar to No. 420, *The United States, Appellant,* v. *The Yale & Towne Manufacturing Company.* The question is whether the munitions tax for 1916 was deductible in computing the net taxable income of the Burton-

Richards Company for 1916, or whether the item was deductible in computing the income for 1917. During the year 1916 the company was engaged in the manufacture and sale of munitions, from which it made a profit of $899,356.32, on which it was required to pay a munitions tax for the year 1916 of 12½ per cent, amounting to $112,419.54. (R. 1–2.) In keeping its books of account the company during the year 1916 accrued and set up on its books various items of income and expense regardless of whether they were due or were paid in that year. Among other items, it set up in 1916 a reserve for munitions taxes for the year 1916, beginning with September, the month of the passage of the Munitions Tax Act, setting aside each month the sum of $35,000. Before closing its books for the year, and under date of December 31, 1916, it readjusted the munitions tax reserve by recalculating the amount and then set up a reserve of $86,541.95 as the amount of the munitions tax, the entry of which on the books operated to reduce the profits of the corporation for the year. (R. 13–15.) In March, 1917, the munitions tax return was filed, showing a tax of $86,541.95. (R. 13.) Thereafter, an examination conducted by the Commissioner of Internal Revenue resulted in the increase of the tax to $112,419.54. (R. 13.) This increase resulted from the fact that in setting up its accounts for 1916 the corporation had charged off as depreciation the entire value of its munitions plant, then in opera-

tion, a depreciation charge which was afterwards disallowed by the Commissioner, who allowed only 10 per cent of the value of the plant as a depreciation charge for 1916.

A statement of the applicable statutes will be omitted because incorporated in the brief in No. 420. The only essential difference between the cases is that in No. 420 it is established that the accounts of the corporation for 1916 were kept on an accrual basis and its income-tax return for that year was made on an accrual basis, while in this case the appellees not only make every point urged by the appellee in No. 420, but also assert that the company's books were kept on a cash receipts and disbursements basis and its return was made on that basis.

ASSIGNMENT OF ERRORS

1. The court erred in holding that the munitions tax on the company's profits for 1916 did not accrue until it became due and payable in 1917.

2. The court erred in holding that, although the company's books of account were kept on an accrual basis and its income-tax return for 1916 was made on the basis on which its books of account were kept, and although the munitions tax for 1916 was entered on its books for 1916 as an accrued liability, it was entitled to deduct the munitions tax in calculating its net taxable income for 1917.

3. The court erred in rendering judgment for the appellees.

ARGUMENT

Summary

I. The only respect in which this case differs from No. 420, The United States, Appellant, v. The Yale & Towne Manufacturing Company, is because of a dispute as to whether the taxpayer's books were kept and its income-tax return made on a cash basis or an accrual basis. As shown in the brief in No. 420, if the cash basis was used, the deduction of the munitions tax for 1916 was properly made in the income-tax return for 1917, the year in which it was paid.

If the accrual basis was used, the deduction could only be made in the income-tax return for 1916, in which year the munitions tax accrued.

II. The Findings show that the books were kept and the return made on the accrual basis.

III. In this, a suit to recover taxes paid, the burden is on the taxpayer to show that the tax was illegally assessed and to overcome the prima facie validity of the assessment, and unless the Findings of the Court of Claims affirmatively show that the books were kept and the income-tax return made on a cash basis they do not sustain the judgment.

IV. Conclusion.

I

The only respect in which this case differs from No. 420, The United States, Appellant, v. The Yale & Towne Manufacturing Company, is because of a dispute as to whether the taxpayer's books were kept on a cash or an accrual basis

If the contention of the taxpayer is right that the Findings by the Court of Claims show that

in 1916 its accounts were kept on a cash basis or that its income-tax return for that year was made on that basis, there is nothing more to be said, because in that case the munitions tax was deductible in the year in which it was paid and not in the year in which it accrued. On the other hand, if the taxpayer's books were kept and its income-tax return for 1916 made on the accrual basis, the principles presented in the Government's brief in No. 420, *The United States, Appellant,* v. *The Yale & Towne Manufacturing Company,* are applicable and the munitions tax for 1916 would be deductible only in 1916, because it accrued in 1916.

In this case the appellees argue that the fact that the munitions tax, accrued on the corporation's books at $86,541.95, was increased by the Commissioner of Internal Revenue to $112,-419.54, shows that the amount of tax at the close of business December 31, 1916, was so uncertain as not to justify an attempt to accrue it, although the taxpayer did make that attempt. This is an unfortunate argument for the appellees. The reason that the increase was made is that the taxpayer charged off as depreciation in computing its profits, on which the munitions tax of 12½ per cent was based, the entire value of its munitions plant, although the plant was still in existence and was being used. This circumstance shows that the failure to accrue the tax at approximately the correct amount resulted from an obviously unjust depreciation charge made by the taxpayer.

II

The Findings show that the books were kept and income-tax return made on an accrual basis

The Findings of the Court of Claims are somewhat meager. They do show that in keeping its books of account the taxpayer set up during the year 1916 a reserve for taxes which were not yet due and which had not been paid. (Finding V, R. 13.) To this extent it is obvious that the books were kept on an accrual basis, and the inference being justified that the taxpayer was consistent it would follow that, in the absence of an express Finding to the contrary, all its accounts were kept on an accrual basis. There is a Finding that expenses amounting to over $2,000,000 "were accrued on the books of the corporation and were taken as deductions without regard to whether said items were paid during 1916 or subsequent years," and among these items were insurance reserve, freight reserve, and bonus reserve. (Finding VIII, R. 14, 15.) These items were the largest items on the books, and, being found by the Court of Claims to have been kept on an accrual basis, sufficiently show that the books of account were kept on an accrual basis. The Finding that no interest was entered on the books for 1916, except such as was actually received or paid (Finding VII, R. 14), is of no significance, because it is expressly found that no other items of interest existed.

The Findings are susceptible only of the construction that the accounts were kept on an accrual basis.

The next question is whether the Findings show that the taxpayer made its return on the basis on which its books were kept (accrual basis) or whether a return was made on a receipts and disbursements basis.

There is no express Finding that the income-tax return for 1916 was or was not made on the basis on which the accounts were kept—that is, on an accrual basis. There are Findings that the item of accrued munitions tax for 1916 carried on the books was omitted from the income tax return for 1916, but reported as a deduction in the return for 1917. (Findings VII, XII, R. 14, 16.) To this extent, and this extent only, the Findings show affirmatively that the basis on which the books of account were kept was departed from in making the income-tax return.

From the other Findings it is fairly inferable that, except for the accrued munitions tax, the income-tax return for 1916 corresponded with the books of account, and the books of account, as the Findings clearly show, were kept on an accrual basis.

There is an express Finding that "accrued" general expenses were "taken as deductions" (Finding VIII, R. 14, 15), which means, no doubt, deductions in the income-tax return, and shows that the return was made on an accrual basis.

III

The burden is on the taxpayer, and unless the Findings affirmatively show that the return was made on a receipts and disbursements basis they do not sustain the judgment

In this case the taxpayer seeks to recover a tax paid, on the ground that it was illegally assessed. The burden of proof is upon him. Furthermore, the assessment by the Commissioner of Internal Revenue is *prima facie* valid and regular. *United States* v. *Rindskopf,* 105 U. S. 418.

If the Findings fail to show affirmatively that the books were kept and the income-tax return made on the accrual basis, it is certain they do not show affirmatively that the return was made on a cash basis, and only an affirmative Finding that the income-tax return for 1916 was made on a cash basis would support the judgment against the United States.

CONCLUSION

For the reasons above stated, and those given in the brief in No. 420, the judgment should be reversed.

WILLIAM D. MITCHELL,
Solicitor General.
JOHN B. MILLIKEN,
Special Attorney,
Bureau of Internal Revenue.

OCTOBER, 1925.

No. 420. THE UNITED STATES, APPELLANT, v. THE YALE & TOWNE MFG. CO.

INDEX

CASES CITED

TEXTBOOKS

STATUTES

In the Supreme Court of the United States

OCTOBER TERM, 1925

No. 420

THE UNITED STATES, APPELLANT,

v.

THE YALE & TOWNE MANUFACTURING COMPANY

APPEAL FROM THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

OPINION IN THE COURT BELOW

The memorandum opinion of the Court of Claims, adopting in this case the opinion in the case of *P. Chauncey Anderson et al.* v. *The United States* (No. 337, October Term, 1925), is not yet reported. It is found at R. 14.

The opinion in the *Anderson* case is not yet reported. It is found at page 17 of the record in No. 337.

GROUNDS OF JURISDICTION

The judgment to be reviewed was entered in the Court of Claims March 23, 1925 (R. 14). Appeal was allowed April 20, 1925 (R. 15), under Sections 242 and 243, Judicial Code.

STATEMENT

This case presents the question whether in computing net taxable income under the Revenue Act of 1916 a munitions tax was deductible from gross income for the year in which the munitions tax was paid or in the year in which it accrued, requiring, in the latter case, a decision as to whether the munitions tax could properly be accrued under an accrual system of accounting in the year in which it was imposed, or only in the year in which it became due.

The appellee, a Connecticut corporation, was engaged in 1916 in manufacturing munitions, its munitions profits for 1916 being $2,045,574, on which there was imposed a munitions tax of 12½ per cent, or $255,696.73. The munitions tax for 1916 became due and was paid in 1917. (R. 11, 12.) The deductibility of the munitions tax in determining net taxable income, for income and excess-profits purposes, is conceded.

The dispute is with respect to the year in which the deduction may be taken.

The Government contends that the deduction should be taken in the income-tax return for 1916; the taxpayer contends that it should be taken in the 1917 return.

The appellee kept its books of account, not on a cash—i. e., a receipts and disbursements basis—but on an accrual basis (R. 12), and made its income-tax return on that basis.

Under that system it set up on its books in 1916 every obligation or expense accruing or incurred without regard to whether it fell due or was paid during the year. (R. 12, 13.)

As part of that system it accrued on its books of account before they were closed for the year 1916, taxes of various kinds for the year 1916, incurred by reason of operations for that year, without regard to whether they were paid or due in that year. The entry was in the form of "reserve for taxes" appearing in the liability column and operating to reduce the amount of the net profits for that year. (R. 12–13.) Included in this reserve was an item of $247,763.19 for munitions tax for the year 1916. (R. 13.)

In February, 1917, a munitions-tax return was filed by the appellee on that basis, and that amount was paid in May, 1917. The return was reviewed by the Collector and an additional munitions tax of $7,933.60 was assessed, which was paid in July, 1917. (R. 12.)

The law required a return of the munitions tax for 1916 to be filed on or before March 1, 1917, and required payment within 30 days after notice from the Commissioner of Internal Revenue, who was required to assess the taxes and issue the notice promptly after the filing of the return. (Sections 304 and 305, Title III, Revenue Act of September 8, 1916, Chap. 463, 39 Stat. 756, 781–782.)

The appellee made its income and excess profits tax return for the year 1916 on the basis on which its books had been kept (the accrual basis), except in so far as it departed from that basis by omitting from its return as an accrued expense or liability the amount of the munitions tax which appeared in its books of account for 1916 as an accrued expense.

In 1918, when making its income tax returns for 1917, appellee treated the munitions tax for 1916 as a deduction or expense for 1917, the year in which it fell due and was paid.

Later, the Commissioner of Internal Revenue held that the munitions tax should have been deducted in the income tax return for 1916 instead of in the return for the year 1917, and the resulting adjustment in these two years, after crediting on the 1917 tax the overassessment for 1916, resulted in a net increase in the 1917 income and profits taxes of $116,044.40, which was assessed and paid under protest, and for the recovery of which after refund was applied for and refused this suit was brought. (R. 9, 10, 12, 14.)

Judgment went against the United States in the Court of Claims.

THE QUESTION

The question is whether the taxpayer, keeping its books of account for 1916 on the accrual basis, and accruing the munitions tax for 1916 on its books as an accrued expense for that year, and

making its income-tax return on the basis on which its books were kept (except in so far as it may have departed from that basis by omitting to make a deduction of the munitions tax for 1916), had the right to deduct the amount of the munitions tax for 1916 from its gross income for 1917, the year in which the munitions tax fell due and was paid, or whether the deduction could only be made in computing its income for the year 1916. In other words, the question is whether the munitions tax was deductible in the year in which it was paid or in the year in which it accrued, and whether it did accrue in 1916 or 1917.

THE STATUTES

The Revenue Act of 1916, Chap. 463, 39 Stat. 756, 765, 767–768, 770–771, 780–781, provides so far as pertinent to this case:

PART II. ON CORPORATIONS

> SEC. 10. That there shall be levied, assessed, collected, and paid annually upon the total net income received in the preceding calendar year from all sources by every corporation, joint-stock company or association, or insurance company, organized in the United States, no matter how created or organized but not including partnerships, a tax of two per centum upon such income
> * * *.
> * * * * *

DEDUCTIONS

SEC. 12. (a) In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—

First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties * * *.

Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade * * *.

Third. The amount of interest paid within the year on its indebtedness to an amount of such indebtedness not in excess of the sum of (a) the entire amount of the paid-up capital stock outstanding at the close of the year, or, if no capital stock, the entire amount of capital employed in the business at the close of the year, and (b) one-half of its interest-bearing indebtedness then outstanding * * *.

Fourth. Taxes paid within the year imposed by the authority of the United States, or its Territories, or possessions, or any foreign country, or under the authority of any State, county, school district, or municipal-

ity, or other taxing subdivision of any State, not including those assessed against local benefits.

* * * * *

RETURNS

SEC. 13 (a) The tax shall be computed upon the net income, as thus ascertained, received within each preceding calendar year ending December thirty-first * * *.

* * * * *

(d) A corporation, joint-stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned * * *.

The munitions tax provisions are as follows:

TITLE III. MUNITION MANUFACTURER'S TAX

SEC. 300. That when used in this title—

The term "person" includes partnerships, corporations, and associations * * *.

SEC. 301. (1) That every person manufacturing (a) gunpowder and other explosives * * * shall pay for each taxable year, in addition to the income tax imposed by Title I, an excise tax of twelve and one-half per centum upon the entire net profits actually received or accrued for said

year from the sale or disposition of such articles manufactured within the United States * * *.

SEC. 302. That in computing net profits under the provisions of this title, for the purpose of the tax there shall be allowed as deductions from the gross amount received or accrued for the taxable year from the sale or disposition of such articles manufactured within the United States the following items:

(a) The cost of raw materials entering into the manufacture;

(b) Running expenses, including rentals, cost of repairs and maintenance, heat, power, insurance, management, salaries, and wages;

(c) Interest paid within the taxable year on debts or loans contracted to meet the needs of the business, and the proceeds of which have been actually used to meet such needs;

(d) Taxes of all kinds paid during the taxable year with respect to the business or property relating to the manufacture;

(e) Losses actually sustained within the taxable year in connection with the business of manufacturing such articles, including losses from fire, flood, storm, or other casualty, and not compensated for by insurance or otherwise; and

(f) A reasonable allowance according to the conditions peculiar to each concern, for amortization of the values of buildings and machinery, account being taken of the exceptional depreciation of special plants.

On January 8, 1917, before the income tax returns for 1916 were required to be made, the Treasury Department, pursuant to Section 13 (d) of Part II of the Act of 1916, issued Treasury Decision 2433 as follows (Treasury Decisions, Vol. 19, p. 5):

> Corporations keeping books in accordance with standard systems of accounting or in conformity with the requirements of some Federal, State, or municipal authority having supervision over such corporations, may make their returns on the basis on which their books are kept, provided the books so kept and the returns so made reflect the true net income of the corporations for each year. [Syllabus.]
>
> TREASURY DEPARTMENT,
> OFFICE OF COMISSIONER
> OF INTERNAL REVENUE,
> *Washington, D. C., January 8, 1917.*
>
> *To collectors of Internal Revenue:*
>
> Subparagraph (d) of Section 13, of Title I of the act of September 8, 1916, provides that—
>
> "A corporation, joint stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury, make its returns upon the basis upon which its accounts are kept, in which case

the tax shall be computed upon its income as so returned."

Under this provision it will be permissible for corporations which accrue on their books monthly or at other stated periods amounts sufficient to meet fixed annual or other charges to deduct from their gross income the amounts so accrued, provided such accruals approximate as nearly as possible the actual liabilities for which the accruals are made, and provided that in cases wherein deductions are made on the accrual basis as hereinbefore indicated income from fixed and determinable sources accruing to the corporations must be returned, for the purpose of the tax, on the same basis.

In cases wherein, pursuant to the consistent practice of accounting of the corporation, or pursuant to the requirements of some Federal, State, or municipal supervising authority, corporations set up and maintain reserves to meet liabilities, the amount of which and the date of payment or maturity of which is not definitely determined or determinable at the time the liability is incurred, it will be permissible for the corporations to deduct from their gross income the amounts credited to such reserves each year, provided that the amounts deductible on account of the reserves shall approximate as nearly as can be determined the actual amounts which experience has demonstrated would be necessary to discharge the liabilities incurred during the year and for the payment of which additions to the re-

serves were made; and provided, if it shall be found that the amount credited to any such reserve is in excess of the reasonable or probable needs of the corporation to meet and discharge the liabilities for which the reserve is credited, the excess of such reserve over and above the reasonable or probable needs for the purpose indicated, shall be at once disallowed as a deduction and restored to income for the purpose of the tax; and provided further, that in no event will sinking funds or other reserves set up to meet additions, betterments, or other capital obligations constitute allowable deductions from gross income.

This ruling contemplates that the income and authorized deductions shall be computed and accounted for on the same basis and that the same practice shall be consistently followed year after year. Amounts paid in discharge of any liability or obligation for which a reserve has been set up, as hereinbefore outlined, will, when paid, be charged to the reserve created to meet it in so far as such reserve is sufficient to meet the liability, provided always that the liability is of a character which constitutes an allowable deduction within the meaning of the law.

If upon investigation it shall be found that returns made upon the basis of accruals and reserves do not reflect the true net income, the corporation so failing in this way to return the true net income will not thereafter be permitted to make its

returns upon any basis other than that of actual receipts and disbursements.

The reserves contemplated by the foregoing ruling are those reserves only which are set up to meet some actual liability incurred, the amount necessary to discharge which can not at the time be definitely determined, and do not contemplate reserves to meet losses contingent upon shrinkage in values, losses from bad debts, capital investments, etc., which losses are deductible only when definitely determined as the result of a closed or completed transaction and are charged off.

W. H. OSBORN,
Commissioner of Internal Revenue.

Approved:

W. G. MCADOO,
Secretary of the Treasury.

ASSIGNMENT OF ERRORS

1. The court erred in holding that the munitions tax on the appellee's profits for 1916 did not accrue until it became due and payable in 1917.

2. The court erred in holding that although the appellee's books of account were kept on an accrual basis and its income-tax return for 1916 was made on the basis on which its books of account were kept, and although the munitions tax for 1916 was entered on its books for 1916 as an accrued liability, it was entitled to deduct the munitions tax in calculating its net taxable income for 1917.

3. The court erred in rendering judgment for the appellee.

ARGUMENT

Summary

I. Under the Revenue Act of 1916 a taxpayer was required to make his income-tax return on the basis of receipts and disbursements, unless he kept his books on an accrual basis, in which case he was permitted to make his return on the basis on which his books were kept.

II. In the present case, as the taxpayer kept its books on the accrual basis and made its income-tax return on that basis, all items of expense, including taxes, must be dealt with on the accrual basis and deductions therefor taken in the year in which the items accrued as distinguished from the year in which they were paid.

III. Under the accrual system of accounting a liability or expense is accrued when all the events have occurred by which liability is determined and the liability has become fixed, even though payment is not due.

The munitions tax for 1916 accrued in 1916, and this taxpayer made no mistake in entering the item on its books for that year as an accrued expense; and in determining its net taxable income the munitions tax was deductible from gross income for the year 1916 and not in the return for 1917.

IV. The cases of United States v. Woodward, 256 U. S. 632, and Ed. Schuster & Co., Inc., v. Williams, 283 Fed. 115, properly understood, do not support the view that a tax, other than an estate tax, does not accrue and is not properly susceptible of being accrued under the accrual system of accounting until it is due.

V. Conclusion.

I

Under the Revenue Act of 1916 a taxpayer was permitted to make his income-tax return on an accrual basis if his books were kept on that basis

A proper understanding of this case requires a review of legislation dealing with the basis for computing Federal income taxes.

The Corporation Excise Tax Law of 1909, Chap. 6, 36 Stat. 11, 112, 113, imposed an annual excise tax upon "the entire net income * * * [of a corporation] received by it from all sources," and provided that such net income be ascertained by deducting from

> the gross amount of the income * * * received within the year from all sources, (first) all the ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties * * *; (second) all losses actually sustained within the year * * *; (third) interest actually paid within the year on its bonded or other indebtedness * * *; (fourth) all sums paid by it within the year for taxes * * *.

That statute plainly required the computation of net income on the basis of actual receipts and disbursements. There was no provision for accrual systems of accounting or for including items of expense incurred but not due and paid.

The first corporation income tax Act of October 3, 1913, under subdivision G of Section II, Chap. 16, 38 Stat. 114, 172, 173, imposed a tax on

> the entire net income arising or accruing from all sources during the preceding calendar year to every corporation,

and provided that such net income should be ascertained

> by deducting from the gross amount of the income of such corporation * * * received within the year from all sources, (first) all the ordinary and necessary expenses paid within the year in the maintenance and operation of its business * * *; (second) all losses actually sustained within the year * * *; (third) the amount of interest accrued and paid within the year on its indebtedness * * *; (fourth) all sums paid by it within the year for taxes * * *.

cash basis

This statute, like the 1909 Act, provided for the calculation of net taxable income on the receipts and disbursements basis.

Under these two Acts some departures from the strict receipts and disbursements basis were permitted by the Commissioner of Internal Revenue, such as the use of inventories. This legislation shows that the subject was undeveloped and the resulting system was a mongrel one, but, in the main, the returns were required to be made on a receipts and disbursements basis. (*Lumber Mutual Fire Ins. Co.* v. *Malley*, 256 Fed. 380; *Maryland Casualty Co.* v. *United States*, 52 Ct. Cls. 201; same case, 251 U. S. 342.)

The first decided shift occurred in the Revenue Act of 1916, evidenced by the insertion of a new provision, section 13 (d).

Section 12 (a) of the Act of 1916, dealing with deductions, followed the same system as did the 1909 and 1913 Acts, allowing as deductions (1) ordinary expenses paid "within the year," (3) the amount of interest "paid within the year," and (4) taxes "paid within the year," the basis specified with respect to deductions, as well as gross income, being the receipts and disbursements basis.

Section 13 (d), however, introduced an alternative method and provided that if a corporation kept its accounts upon any basis other than that of actual receipts and disbursements it might, subject to regulations made by the Commissioner, make its return "upon the basis upon which its accounts are kept."

This allowed the taxpayer the option to make his return on a cash basis without regard to how he kept his books, or if he kept his books on some other basis to make his return upon the basis upon which his accounts were kept.

Montgomery's Income Tax Procedure, 1918, pp. 67–68, referring to the accrual system under the Revenue Act of 1916, says:

> Section 8 (g) of the law as applied to individuals, and Section 13 (d) as to corporations, provide for the return of

> "accrued" income as distinguished from "received."
>
> * * * * *
>
> The 1913 law was sadly lacking in correct phraseology, and no one, not even the framers of the law, knew whether income "received" or "accrued" was to be reported, or whether expenses "paid" or "incurred" or "accrued" were to be deducted.
>
> The law of September 8, 1916, cleared up all of these ambiguities and made it possible for the Commissioner of Internal Revenue to permit returns to be made which would accord exactly with the books of account of well-regulated concerns. The provision of the law referred to is quoted in T. D. 2433 * * *.

In connection with the accrual basis offered as an alternative by the 1916 Act, the Treasury Department, in T. D. 2433, issued January 8, 1917 (page 19 herein), approved of the practice of setting up and maintaining reserves to meet liabilities accrued but not yet due and including those the amount of which may not have been definitely determined.

The next shift was made in the 1918 Act (the Act of February 24, 1919, Chap, 18, 40 Stat. 1057). In Section 200 it was provided (40 Stat. 1059):

> The term "paid" for the purposes of deductions and credits under this title, means "paid or accrued" or "paid or incurred," and the terms "paid or incurred"

and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212.

Section 212 (b) provided (40 Stat. 1064):

> The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the the method of accounting regularly employed in keeping the books of such taxpayer * * *.

Section 222 (b) provided relative to credits for taxes (40 Stat. 1073):

> If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the Commissioner, who shall redetermine the amount of the tax due under Part II of this title for the year or years affected, etc.

Section 232 (40 Stat. 1077) provided that the returns of corporations should be on the same basis as those of individuals.

Section 238 (a), relating to credits for taxes in the case of corporate returns (40 Stat. 1080), contained the same provision as Section 222 (b) providing for readjustments in case the amount of taxes accrued upon the books differed from the amount ultimately paid.

These provisions of the 1918 Act deprived the taxpayer of the option he had under the 1916 Act of making his returns on a cash receipts and disbursements basis, or (if he kept his books on another basis) on the basis on which his books were kept, and limited the taxpayer to making his return on the basis on which his books were kept provided the basis tended to correctly show net income.

Although Section 12 (a) of the Act of 1916, dealing with deductions, provided for the deduction of "expenses *paid* within the year" and "losses actually sustained" within the year, and "interest *paid* within the year," thus providing for the deduction of all these items of expense in the year in which they were paid, placing the entire return on a receipts and disbursements basis, it can hardly be seriously disputed that Section 13 (d) provided for an alternative method permitting the taxpayer if he kept his books on an accrual basis to make his return on that basis, deducting expenses accrued within the year and interest accrued within the year and taxes accrued within the year. It is clear, too, that if the taxpayer used the accrual basis in keeping his accounts and made his return on that basis he could not be permitted to depart from the accrual basis in dealing with any item of expense.

II

In the present case the taxpayer kept its books on the accrual basis and made its return on that basis, and the munitions tax must be deducted in the year in which it accrued, as distinguished from the year in which it was paid

In the present case the appellee's income tax returns were not made on the receipts and disbursements basis.

It kept its books on an accrual basis and it elected to make its return and have its income-tax return computed on the basis on which its books were kept. In 1916, in the regular course of business, keeping its books on an accrual basis, the appellee deemed it proper to enter in its books of account for that year, as an accrued expense or liability, the estimated amount of the munitions tax for that year. It evidently considered that the consistent use of the accrual system required this treatment of the munitions tax and that the munitions tax was, in its nature, susceptible of being properly accrued upon its books as an expense for that year.

In making its income-tax return for 1916, although basing its return in other respects on its books of account, and making its return in other respects, both as to gross income and deductions, on the accrual basis, it attempted to make an exception of the munitions-tax item, and, instead of including it as an accrued expense for 1916 in the income-tax return for that year, omitted it entirely,

and a year later, in making its income-tax return for 1917, treated the 1916 munitions tax as a 1917 expense.

The appellee's position seems to be that, conceding that it kept its books on an accrual basis, and that, as a part of that system, it accrued the munitions tax in 1916 on its books for that year, nevertheless it was justified in departing from its books in making its return by eliminating the item of accrued munitions tax. If any justification for this exists, it must be that the munitions tax did not accrue in 1916 and was not susceptible of being accrued in 1916 under the accrual system of accounting, and this brings us to the ultimate question in the case.

III

Under the accrual system an expense accrues when all the events have occurred from which liability is determined and the liability has become fixed, even though payment is not yet due. The munitions tax for 1916 accrued in 1916, and the taxpayer made no mistake in entering the item on its books for that year as an accrued expense

The word "accrue" is used in different connections. Under statutes of limitation, a claim or cause of action is said to accrue when it becomes due and enforceable and an action may be immediately maintained. The word is sometimes used to indicate a liability which is due. Under the accrual system of accounting, however, income is said

to be accrued when it is definitely receivable, although its payment may not be due, and liabilities or expenses are said to be accrued when the events have occurred from which liability is determined and the liability has become fixed, even though payment is not yet due. The basic idea under the accrual system of accounting is that the books shall immediately reflect obligations and expense definitely incurred and income definitely earned without regard to whether payment has been made or whether payment is due. Income derived from the sale of merchandise in 1916 is properly accrued on the books for 1916, although payment may not be due until the following year. Expenses of any kind definitely incurred in the operations for a particular year are properly accrued in the accounts for that year, although payment may not be due until the following year. Under this system, the use of the word "accrued" does not signify that the item is due. On the contrary, the accrual system wholly disregards due dates. Neither is it necessary that the amount of an incurred liability be accurately ascertainable in order to "accrue" it.

Excerpts from standard works on accounting on this subject are in the Appendix, p. 61.

The munitions tax for 1916 is based on the amount of munitions profits for that year; it was an actual expense or element of cost in the production of the income for that year; the law imposing the tax was in force during that year;

definite liability to pay the tax had arisen by the end of the year; every fact or circumstance affecting the amount of the tax had occurred by the end of the year, and no fact or event occurring after the end of the year was a factor in the computation or determination of the tax. By the close of the year, liability for the tax had become definitely fixed, the tax being based on the result of operations for 1916, which were closed December 31, 1916. Neither liability for the tax nor the amount properly payable could be affected under the law by anything occurring after December 31, 1916.

It is true the monthly estimates of the amount of the tax appearing in the monthly trial balances during the year 1916 were tentative and might vary up or down from month to month, and required final correction in closing the books for the year, but if the accounts of the corporation were correctly kept and its profits computed in the manner required by law, the amount of the munitions tax was definitely ascertainable at the end of the year. In this case the taxpayer knew the amount of the munitions tax at the close of the year when it entered the reserve on its books as well as it did when the return was made and the tax paid. The fact that a difference of opinion might arise after December 31, 1916, between the taxpayer and the Commissioner of Internal Revenue as to what was a reasonable depreciation on plant and equipment, or as to other items of that nature, did not provide

new factors occurring after December 31, 1916, varying the tax. Any other conclusion would mean that no such item could be properly accrued until the statute of limitations had run against the Government or the matter had been settled by a conclusive agreement between the taxpayer and the Government.

The accrual by the taxpayer of this tax on its books for 1916 was not only proper and in accordance with good accounting practice but was expressly approved by T. D. 2433, set forth above.

IV

Cases of United States v. Woodward, 256 U. S. 632, and Ed. Schuster & Company, Inc., v. Williams, 283 Fed. 115

The principal ground for the contention of the taxpayer that the munitions tax for 1916 did not accrue and could not be properly accrued on the books in 1916 is that the tax did not accrue until it was due, and the authority urged in support of this proposition is the case of *United States* v. *Woodward,* 256 U. S. 632. It is asserted that the *Woodward* case holds that no tax accrues, so that it may properly be accrued on the books of the taxpayer, until the tax is due, and therefore the accrual by the appellee of a munitions tax for 1916 on its books for that year was improper and the item was properly disregarded in making its return for that year, but was deductible in 1917 in calculating income for that year.

The *Woodward* case dealt with a Federal estate tax. Woodward died December 15, 1917. Under Section 204 of the Revenue Act of 1916 it was provided: "That the tax shall be due one year after the decedent's death." The tax was actually paid February 8, 1919. Two questions were involved: (1) Were the executors in making income-tax returns for the period of the administration of the estate entitled to deduct the Federal estate tax from gross income? And (2) if the deduction was proper, in what year should it be made?

The Court held that the tax accrued in 1918, because it was due in 1918, and that it was deductible in the income-tax return of the executors for that year. The main question dealt with was the deductibility of the Federal estate tax. The question as to the year in which the deduction could be taken was given scant consideration in the briefs.

The quotations from the Revenue Act of 1918 applicable to the *Woodward* case, found on pages 27–28 of this brief, show that in order to determine in the *Woodward* case whether the estate tax, if deductible, was deductible in the year in which it was paid, which was 1919, or in the year in which it accrued, which the Court held to be 1918, it was essential that the basis on which the executors kept their accounts should be disclosed.

Under the terms of the 1918 Act, the income-tax return was required to be made on the basis on which the books were kept. If that basis was a receipts and disbursements basis, it is plain that

in the *Woodward* case the estate tax would be deductible in 1919, the year in which it was paid, but if the books of the executors were kept on an accrual basis the estate tax would be deductible in the return for 1918 on the assumption that it accrued in that year.

Nowhere in the record or in the briefs in the Woodward case is any mention made of this subject, nor were the provisions of Sections 200, 212 (b) and 222 (b) of the 1918 Act referred to or called to the attention of the Court, and there was nothing in the record from which to determine on what basis the executors kept their accounts. This situation is mentioned to show that little attention was paid to the question of the year of the deduction in the presentation of that case, and that the accrual system of accounting, and the sense in which the word " accrue " is used in that system, were not considered.

Passing over this point, however, the Court did hold in the opinion that the Federal estate tax in the *Woodward* case accrued when it fell due under the terms of the statute, on December 15, 1918, and that it did not accrue December 15, 1917, when the decedent died, nor between that date and January 1, 1918.

In the Government's brief (of 48 pages) one page is given to the question as to when the estate tax accrued, stating merely that the law allowed the deduction of taxes paid or accrued within the taxable year; that the estate tax was a death duty;

that it accrued at the moment of death, and, consequently, accrued in 1917; that it was paid in 1919; that it therefore neither accrued nor was paid in 1918.

In the brief for the executors in the *Woodward* case, the only reference to this subject was as follows (p. 15):

> The decedent died December 15, 1917, and this tax was due and payable, or accrued, December 15, 1918, and was paid by the executors February 8, 1919.

All that the Court said on the subject was (p. 635):

> Here the estate tax not only "accrued," which means became due, during the taxable year of 1918, but it was paid before the income for that year was returned or required to be returned.

It is thus evident that in the presentation of the *Woodward* case the accrual system of accounting and the propriety of accruing items of expense under that system were not mentioned.

Nevertheless, we do not need to question the soundness of the conclusion reached in that case that the Federal estate tax accrued in 1918. The Court did not hold, however, that every tax, of every nature, and under every circumstance accrues on the date it falls due, and not before.

A radical difference between the circumstances affecting the accrual of a Federal estate tax and

those affecting the accrual of a munitions tax is obvious.

Section 203, Subdivision (a) (1), of the Revenue Act of 1916 (39 Stat. 778), applicable to the *Woodward* case and prescribing the method of determining the value of the net estate, provided for the deduction from the gross estate of—

> Such amounts for funeral expenses, administration expenses, * * * losses incurred during the settlement of the estate arising from fires, storms, shipwreck, or other casualty, and from theft, when such losses are not compensated for by insurance or otherwise, support during the settlement of the estate of those dependent upon the decedent, and such other charges against the estate, as are allowed by the laws of the jurisdiction, etc.

Woodward died December 15, 1917. It is obvious there were reasons for saying that the Federal estate tax could not properly be said to have accrued on December 15, 1917, or between that date and January 1, 1918. The provisions of Section 203 above quoted show that in the determination of the net estate, and therefore the amount of the tax, *various events subsequent to the date of the decedent's death and continuing through the period of administration were necessary factors in computing the amount of the tax.* There was not only no basis for accrual December 15, 1917, or prior to January 1, 1918, but an attempted accrual would

have been a mere speculation. The Court was right, therefore, in holding that the tax could not properly be said to have accrued between December 15, 1917, and January 1, 1918. The next step was to determine whether it accrued in 1918 or not until paid in 1919. By the terms of Section 204 it was expressly provided that the tax should be due December 15, 1918, and notwithstanding the same uncertain factors entering into the computation of the estate tax might continue to exist one year after the decedent's death, and indeed so long as the administration continued, nevertheless the statute required that the tax should be determined at the expiration of one year from the best information available and then be due, and no doubt the Court in the *Woodward* case would have found difficulty in holding that the tax had not accrued or was not accruable even though it was due. For the reasons stated and because of the allowable deductions from the gross estate on account of events occurring during the entire administration, an estate tax is in a class by itself. So long as administration continues and is not closed, events are occurring involving expenses of administration, losses from casualty, support of dependents, etc., which are continuing factors altering the amount of the tax. The tax can not be finally determined until the administration is closed, and yet it must be estimated and paid before the administration is closed. This peculiarity of estate taxes and inheri-

tance taxes has been recognized in the Revenue Act of 1924, in which, in Section 214, Subdivision (a) (3), relating to deductions allowed individuals in computing net taxable income and in authorizing a deduction of taxes paid or accrued within the taxable year, Congress adopted the rule with respect to estate taxes laid down in the *Woodward* case by providing (43 Stat. 270):

> For the purpose of this paragraph, estate, inheritance, legacy, and succession taxes accrue on the due date thereof except as otherwise provided by the law of the jurisdiction imposing such taxes * * *.

The difference between the munitions tax of 1916 and a Federal estate tax is obvious. Every event constituting a factor in the ascertainment of the amount of the munitions tax had occurred at the close of business December 31, 1916. No business operation after that date could affect the amount of the tax. The factors constituting the basis for computation of the tax were all determined and known. The tax was an actual expense or element of cost in the production of income for 1916, and the fact that it was accruable and properly so under an accrual system of bookkeeping is evidenced by the act of the taxpayer in accruing it upon its books at the close of business for that year in order to fairly and honestly reflect the profits divisible to the stockholders. The liability under existing law had arisen at the close of business in 1916, and if the corporation had ceased to operate

at the close of 1916 its liability for the tax and the amount of the tax would not have varied or been affected.

Many kinds of taxes constitute an expense for the year in which they are levied—a contribution to the Government for the protection of the taxpayer's property during that year—and according to common practice accounts kept on an accrual basis properly include an accrual of such taxes at the close of the year in which and for which they are levied, although not due until the following year. To give to the statement in the *Woodward* case the effect claimed by the appellee, namely, that no tax is accruable or properly accrued until it is *due* would upset systems of accounting on an accrual basis on which current taxes for the year under consideration are commonly accrued. There is no more reason to hold that a tax like the munitions tax can not be accrued until it is due than there is to hold that interest can not be accrued until it is due. The tax has been irrevocably incurred, liability exists and is not contingent, and the events constituting the factors in the determination of the amount have happened. The real basis for determining whether a tax is properly accruable or accrued is whether the events have happened which fix liability. In the case of this munitions tax these events had happened by December 31, 1916. In the *Woodward* case they had not happened even at the time the tax was made due by the terms of the statute.

The other case referred to by the appellee with confidence is that of *Ed. Schuster & Co., Inc.*, v. *Williams*, 283 Fed. 115, a decision by the Circuit Court of Appeals for the Seventh Circuit. In that case it appeared that in 1919, effective October 10, 1919, an act was passed in Wisconsin known as the Soldiers Bonus Act, which provided for the raising of the entire bonus by one levy, which included a surtax over the normal tax upon the incomes of corporations upon the basis of their income-tax returns for 1918. The question in that case was whether, in determining the Federal income tax of the taxpayer, this State surtax was deductible from the income of 1918 or from the income of 1919. The taxpayer's returns were made on the accrual basis and its books were evidently kept on that basis, and it attempted, after the Bonus Act was passed, to revise its return for the previous year so as to "accrue" the bonus surtax as an expense of 1918, merely because the 1918 income was made the basis for the levy. The court was obviously right in holding that this could not be done. The bonus surtax had not been accrued upon the books of the corporation in 1918 for the obvious reason that the statute under which the tax was levied was not passed until October 10, 1919. At the close of business in 1918 no obligation had arisen under any existing statute for the payment of any such tax. What the legislature did was to impose the tax in 1919 under a statute passed in that year, and it merely adopted the net taxable income of the pre-

vious year as the basis for the tax. It might as well have chosen as a basis for the levy the average net income of five previous years or selected the net income of either 1915, 1916, or 1917 as a basis. There was at the close of business in December, 1918, manifestly no basis on which a tax not then imposed and arising under a law not then enacted could have been accrued under any system of accounting, and the fact that the legislature used the 1918 income as the basis for computing the tax did not make the tax a 1918 expense or one entering into the determination of the profits of 1918. The court makes this perfectly plain in its opinion holding that "there is no necessary relation between the basis for the levy, and the time of the accrual of the tax." In the present case we are dealing with a tax arising under a statute in force in 1916, creating a liability which existed at the close of business in December, 1916, and the amount of which was fixed and determined by events happening during 1916.

It is suggested that the shifting of the basis for income-tax returns from the cash receipts and disbursements basis to an accrual basis might operate in the process to prevent the taxpayer from receiving credit as a deduction for some items which were not deductible while the cash system was in effect because not actually paid, and could not be deducted when the accrual system was adopted because they had previously accrued. Such situations do arise where a shifting basis for income

taxes is adopted, and a corollary of the proposition is that some items of income which have been earned never have to be reported. Whether such a shift in the basis for the making of income-tax returns works to the advantage or disadvantage of any particular taxpayer does not render the statute invalid nor require its terms to be ignored.

The suggestion that the possibility that the munitions tax law in effect in 1916 might have been repealed before the tax became due prevented the tax from accruing in 1916 is plainly without merit.

An instruction which appeared on the form of income-tax return for 1916 is relied on by appellee as showing that the Treasury Department has not always been consistent in dealing with this subject, and there are some opinions by the Board of Tax Appeals in which it is said that a tax does not accrue until it is due—a statement evidently based on a misunderstanding of the *Woodward* case. The law is clear, however, and Treasury Decision 2433, issued in January, 1917, having the force of law, properly construed it. An able opinion of the Solicitor of Internal Revenue on the point, rendered in 1921, is printed as an Appendix to this brief.

CONCLUSION

It is submitted that as this taxpayer kept its books on an accrual basis, and elected to make its return on that basis, it should be required to adhere consistently to that basis, and not convert one

item from an accrual basis to a cash basis, transposing it from 1916 to 1917. The nature of the munitions tax was such that under an accrual system of accounting it was proper for the taxpayer to enter the item as an accrued expense in the form of a reserve for taxes upon its books for 1916, and it can not be successfully contended that the tax was of such a nature as not to be properly subject to accrual until 1917, and for these reasons the judgment should be reversed.

Respectfully submitted.

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OCTOBER, 1925.

APPENDIX A

CUMULATIVE BULLETIN NO. 4 (JANUARY–JUNE, 1921), BUREAU OF INTERNAL REVENUE, TREASURY DEPARTMENT, "INCOME TAX RULINGS," P. 147

SECTION 214(a) 3, ARTICLE 131:
Taxes. 10–21–1503
(Also Section 212, Article 23.) L. O. 1059

Corporation Income Tax—Revenue Act of 1916, section 12(a); section 13(d)

METHOD OF COMPUTING AND ACCOUNTING FOR MUNITION MANUFACTURER'S TAX WHEN TAXPAYER'S ACCOUNTS ARE KEPT ON THE ACCRUAL BASIS

Where a corporation in 1916 kept its accounts on the accrual basis, and either accrued munition taxes or credited amounts to a reserve set up to meet such taxes, thus taking advantage of section 13(d) of the Revenue Act of 1916, it became bound by the provisions of that section and Treasury Decision 2433, and the amounts so accrued or credited must, in computing income subject to tax for 1916, be deducted from gross income for that year, and not for 1917, during which year such munitions taxes were paid.

Section 13(d) of the Revenue Act of 1916 is a qualifying section, and when accounts of a corporation are kept on a basis other than that of receipts and disbursements it qualifies the manner of making deductions

authorized in section 12(a) of the Act, and the word "paid" in the latter section is to be read "paid or accrued," depending on how the accounts of the corporation are kept. [Syllabus.]

The question is presented whether the M Company, a corporation, considering the basis upon which its accounts are kept, is required, in computing its income tax for the calendar year 1916, to accrue munitions taxes assessed against the company under Title III of the Revenue Act of 1916, and deduct the amount thereof from gross income in its tax return for that year.

The company, in its tax return for 1916, made no deduction from gross income on account of munitions taxes assessed for that year, but claims the right to and did deduct the amount of such taxes in its tax return for 1917. This was in accordance with the consistent policy of the company, which has made it a practice since 1912 to deduct in its tax returns only the amount of taxes actually paid during the year for which the returns were rendered.

The munition manufacturer's tax is an excise tax of twelve and one-half per centum upon the entire net profits actually received or accrued for the year 1916 from the sale or disposition of certain articles therein specified, manufactured in the United States.

In computing net income subject to tax under Part II of Title I of the Revenue Act of 1916, domestic corporations were allowed certain deductions from their gross income. Those deductions are enumerated in section 12(a) of the Act.

The provisions relating to general items of expense and taxes read as follows:

> SEC. 12(a). In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—
>
> First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity.
>
> * * * * *
>
> Fourth. Taxes paid within the year imposed by the authority of the United States, * * * or of its Territories, or possessions, or any foreign country, or by the authority of any State, county, school district, or municipality, or other taxing subdivision of any State, not including those assessed against local benefits.

The proper treatment of the item munitions taxes for income-tax purposes depends not only upon the construction to be placed on the word "paid" as used in this section, but also upon the effect of section 13 (d) of the Act concerning the methods of keeping accounts, and Treasury Decision 2433.

Under revenue acts prior to the Revenue Act of 1916, the only recognized basis for keeping accounts was that of actual receipts and disbursements. Giving official recognition to the fact that it is the common practice for all large business enterprises

to keep their accounts on the accrual basis, this Department permitted the accrual of certain items of expense and the use of inventories. This practice was adopted to effectuate as nearly as possible, without doing violence to the language employed, the real purpose of those Acts, namely, to reflect the true income of the taxpayer upon which the tax was levied. However, taxes were not permitted to be accrued. They were deductible only in the year in which actually paid, and this remained the practice at least until the Revenue Act of 1916 became effective.

Section 13 (d) of the Revenue Act of 1916 is as follows:

> A corporation, joint-stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned.

This is the first time the law specifically recognized keeping accounts, for income-tax purposes, on any basis other than that of receipts and disbursements, and even then no other basis was to be used if the taxpayer's income thereunder was not clearly reflected, and in no event was another basis to be used unless it was in conformity with regulations made by the Commissioner with the approval of the Secretary. Formal consent in each individual case upon application made to making returns

of income on the basis upon which accounts were kept was not necessary. But there were two necessary requisites: First, the accounts must have clearly reflected true income; second, if a system other than receipts and disbursements were used, it must have been subject to regulations made by the Commissioner.

This Act was approved September 8, 1916, and shortly thereafter on January 8, 1917, Treasury Decision 2433 was approved by the Secretary. This Treasury decision, after quoting section 13(d) as above, reads as follows:

> Under this provision it will be permissible for corporations which accrue on their books monthly or at other stated periods amounts sufficient to meet fixed annual or other charges to deduct from their gross income the amounts so accrued, provided such accruals approximate as nearly as possible the actual liabilities for which the accruals are made, and provided that in cases wherein deductions are made on the accrual basis as hereinbefore indicated, income from fixed and determinable sources accruing to the corporations must be returned, for the purpose of the tax, on the same basis.
>
> In cases wherein, pursuant to the consistent practice of accounting of the corporation, or pursuant to the requirements of some Federal, State, or municipal supervising authority, corporations set up and maintain reserves to meet liabilities, the amount of which and the date of payment or maturity of which is not definitely determined or determinable at the time the liability is incurred, it will be permissible for the corporations to deduct from their gross income the amounts credited to such reserves

each year, provided that the amounts deductible on account of the reserves shall approximate as nearly as can be determined the actual amounts which experience has demonstrated would be necessary to discharge the liabilities incurred during the year and for the payment of which additions to the reserves were made; and provided if it shall be found that the amount credited to any such reserve is in excess of the reasonable or probable needs of the corporation to meet and discharge the liabilities for which the reserve is credited, the excess of such reserve over and above the reasonable or probable needs for the purpose indicated shall be at once disallowed as a deduction and restored to income for the purpose of the tax; and provided further that in no event will sinking funds or other reserves set up to meet additions, betterments, or other capital obligations constitute allowable deductions from gross income.

This ruling contemplates that the income and authorized deductions shall be computed and accounted for on the same basis and that the same practice shall be consistently followed year after year. Amounts paid in discharge of any liability or obligation for which a reserve has been set up, as hereinbefore outlined, will, when paid, be charged to the reserve created to meet it in so far as such reserve is sufficient to meet the liability, provided always that the liability is of a character which constitutes an allowable deduction within the meaning of the law.

If upon investigation it shall be found that returns made upon the basis of accruals and reserves do not reflect the true net income, the corporation so failing in this way to return the true net income will not thereafter be permitted to make its returns upon

any basis other than that of actual receipts and disbursements.

The reserves contemplated by the foregoing ruling are those reserves only which are set up to meet some actual liability incurred, the amount necessary to discharge which can not at the time be definitely determined, and do not contemplate reserves to meet losses contingent upon shrinkage in values, losses from bad debts, capital investments, etc., which losses are deductible only when definitely determined as the result of a closed or completed transaction and are charged off.

The company contends, notwithstanding section 13(d) and Treasury Decision 2433, that the wording of the statute, "Taxes paid within the year" precludes their deduction in any year except that in which they were actually paid. If this be true, we have a peculiar and anomalous situation in connection with the company's returns. It admits, and its returns so show, that the ordinary and necessary expenses incurred within the year 1916 in the maintenance and operation of its business and property, provided for in the first subdivision of section 12(a), were accrued on its books and deducted in its tax return for 1916, whether or not such expenses were actually paid within that year. Likewise, all items of income, whether or not actually received, were accrued and included in gross income. So far as the statute is concerned, there is nothing to indicate that the expenses referred to in the first subdivision of section 12(a) should be accrued and deducted as accrued, and that taxes referred to in subdivision 4 thereof should be deducted only in the year

in which paid. The word "paid" is used in identically the same manner in both subdivisions without qualifying words, and according to rules of statutory construction the deductions classified thereunder must receive like treatment.

There would be great force to the argument that the wording of the statute "Taxes paid within the year" precludes their deduction in any year except that within which they are actually paid were it not for section 13(d). In construing a statute, full consideration must be given to all its provisions, and a construction adopted that will permit all sections to harmonize if possible. In framing the Revenue Act of 1916 it was contemplated, as theretofore, that accounts ordinarily were kept on the receipts and disbursements basis; hence the use of the word "paid" in connection with all items of deductions enumerated in section 12(a). But desiring to recognize other systems of keeping accounts, section 13(d) was inserted, which was designed especially to recognize the system of accrued accounting; that is, that all items of income and outgo be either actually determined or estimated as they accrue and that the proper entries be made upon the books at that time, returns of income be made on that basis, and the tax paid accordingly. To this extent, then, section 13 (d) is a qualifying section, and when accounts are kept on the accrual basis, so as to bring the taxpayer within this section, it qualifies the word "paid" and the manner of making deductions allowed in section 12(a). The word "paid," therefore, is to be read "paid or accrued," depending on how the accounts of the taxpayer are kept.

It is further contended by the company that it did not accrue munitions taxes, but only set up a reserve to meet this liability, the amount of which was not definitely determined until some time in 1917, and even if these taxes were accrued on its books it is still proper, in view of the wording of the statute, and the fact that Treasury Decision 2433 merely gives corporations permission to use the accrual basis and does not require it to deduct taxes only in the year in which paid. The company attempts to draw a fine distinction between accruals and reserves, the only difference being, so far as its brief shows, that a liability is accrued when the amount thereof is definitely ascertainable and a reserve is set up to meet a liability when the amount thereof can not be accurately determined. It also relies on articles 152, 156, and 158 of Regulations 33, promulgated January 5, 1914, as governing the method of computing and accounting for deductions of taxes for 1916.

From reports of the revenue agents, copies of actual book entries taken from the books of the company, and statements submitted by officers of the company, I am convinced the taxes in question were accrued on the books of the company. The statement furnished by the revenue agent starts with the year 1915, and sets up the distribution made by the N Company and followed for the remainder of the year by its successor, the M Company. In that year the company accrued income taxes. In July, 1916, the successor company began to set aside monthly amounts chargeable against the earnings of that year through "Undistributed Expense," these amounts being credited to the account "Federal Munitions Tax, 1916." That the

intention of the company was to accrue munitions taxes is shown by the explanations appearing on its books with reference to entries made in this account. The word "accrued" is used several times in specifying amounts accrued to certain dates. The balance sheets of the company reflect the liability for that year in item "Deferred Credits." The schedule of this account sets up the compilation, which includes income taxes for 1916, x dollars; munitions tax for 1916, $5x$ dollars; accrued expenses, $4x$ dollars; total, $10x$ dollars.

The method of keeping this account discloses that instead of a general reserve being set up as an extra safeguard to take care of a possible but unknown liability, the company accrued from month to month the estimated amount of munitions taxes it was required to pay and so constituted it a liability against the company's assets. This amount should not have been difficult to estimate, it being, as has been stated, twelve and one-half per centum of the net profits received during the year on the manufacture of certain products. Under the accounting method employed by the company it undoubtedly could estimate with great accuracy its probable profits from munitions operations, even though they could not be absolutely determined. While there may be a technical distinction in accounting between an accrual and a reserve, the setting up of a reserve is not inconsistent with the system of accrued accounting. Neither do I find anything in the law that distinguishes between them. The law looks only to whether the liability was actually incurred and does not prohibit the deduction of a proper reserve set-up to meet a known liability that is a proper deduction. Law Opinion

360. Therefore, the fact that the company failed to make an accurate estimate of its munitions taxes for 1916 is not sufficient reason for deducting the amount of such taxes in 1917. Few accrued liabilities are estimated with absolute accuracy, and it is generally necessary to make adjustments from time to time in these accounts as the situation requires. This fact is recognized in Treasury Decision 2433.

We come now to the question of the effect of this Treasury decision. It is unnecessary to enter into a discussion of whether under the language used therein corporations were merely given permission or were required to use the accrual system of keeping accounts. It is sufficient to note that this company not only kept its accounts on the accrual basis, accruing munitions and other taxes, but rendered its tax returns on that basis, with the one exception that taxes were deducted in the year in which paid. In this respect there was a departure from the established method of accounting not warranted by the law or regulations. Having elected to report its income subject to tax on the basis on which its accounts were kept, thus taking advantage of section 13(d), which brought it within the provisions of this section and Treasury Decision 2433, the company became bound by its election and, having decided to accrue income, it must go the whole way and accrue liabilities instead of accounting for them on a different basis, except where the Act specifically provides otherwise. Neither can it use one method in making one deduction and a totally different method in making another deduction. The reason for this is obvious. Take, for instance, the item under discussion. Munitions taxes are an

element of cost entering into every unit of production and which must be taken into consideration each year in computing net income subject to tax. It is an expense necessary to produce income, and income is improperly reflected if the deduction on this account is made the following year, as it is in no way related to the income of the latter year, and has the further effect of greatly inflating the income of the year to which it does relate. Such practice would be contrary to the provision contained in the first sentence of paragraph four of Treasury Decision 2433, which contemplates "that the *income and authorized deductions shall be computed and accounted for on the same basis* and that the same practice shall be consistently followed year after year," and to the provisions of section 13(d) which permit returns to be made on a basis other than that of receipts and disbursements only when income is properly reflected.

But whether the amounts set aside to cover munitions taxes were accrued or set up as a reserve should not, in my opinion, make any difference so far as this case is concerned. The Treasury decision referred to provides for deducting from gross income amounts credited to reserves each year to meet liabilities, the amount and date of payment of which are not definitely determined or determinable at the time the liability is incurred. As stated in Law Opinion 360:

> * * * With respect to a corporation making its return on an accrual basis, the crediting of an amount to a reserve to meet a given liability is equivalent to the payment of such liability by a corporation making its return on the basis of actual re-

> ceipts and expenditures, subject only to the requirement that, if such reserve is "in excess of the reasonable or probable needs of the corporation," amounts so credited shall be restored to income. *An amount credited to a reserve in 1916 is deducted, if at all, from income for the year 1916.* Whether or not it shall be deducted depends therefore upon the law in force in 1916. * * * The sole question is as to the character of the reserve and that it is to be determined by the law at the time when amounts are credited to it rather than by the law at the time when payments are made from it.

It would, therefore, appear that even though this is a reserve for munitions taxes it must be deducted from gross income in 1916 *or not at all.* See A. R. M. 26, page 115, and A. R. M. 29, page 119, Cumulative Bulletin No. 2, 1920.

Articles 152, 156, and 158 of Regulations 33 promulgated January 5, 1914, are not applicable. Those regulations were adopted in pursuance of the Act of October 3, 1913, which did not recognize the accrual method of accounting, and the articles in question could have no application in this case where advantage was taken of a new provision in a different Act, and in connection with which Treasury Decision 2433, which is inconsistent with those articles, was issued. For the same reason, the practice of the company established prior to 1916 of deducting taxes only in the year in which paid is not to be considered. What the company did in this respect prior to 1916, its 1916 return having been made under a new Act, has no bearing on the question here at

issue, as the question arose under the new and not the old Act, the Acts being dissimilar.

It is held that where a corporation in 1916 kept its accounts on the accrual basis, and either accrued munitions taxes or credited amounts to a reserve set up to meet such taxes, thus taking advantage of section 13 (d) of the Revenue Act of 1916, it became bound by the provisions of that section and Treasury Decision 2433, and the amounts so accrued or credited must, in computing income subject to tax for 1916, be deducted from gross income for that year, and not for 1917, during which year such munitions taxes were paid.

Section 13 (d) of the Revenue Act of 1916 is a qualifying section and when accounts of a corporation are kept on a basis other than that of receipts and disbursements, it qualifies the manner of making deductions authorized in section 12 (a) of the Act, and the word "paid" in the latter section is to be read "paid or accrued," depending on how the accounts of the corporation are kept.

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Solicitor of Internal Revenue.

APPENDIX B

In *Montgomery, Auditing Theory and Practice* (3rd Ed.) Vol. 1, pp. 495, 496, we find the following discussion:

> *The Accrual Method:* To be correct the income account for a given period must contain all of the earnings or revenue and all the expenses or costs applicable to that period. All transactions during the current period which apply to a previous period should have been included in that period, and all transactions which belong to the succeeding period or periods must be deferred. *In the former case, if proper reserves were set up for the items, no adjustment is necessary in the current period.* * * *
>
> *It is hardly possible that an accurate balance sheet or income account of any business can be prepared unless the accrual basis is adopted.* Concerns which close their books immediately after the end of a fiscal period almost always fail to include some items which belong to that period. *In practically all cases the omitted items are expenses, rather than earnings, so that the errors due to omission usually unduly increase the net income.* It is therefore important for an auditor to advise that books be left open long enough to ascertain the amount of liabilities which have been incurred but not discharged at the closing date. [Italics ours.]

Montgomery, Auditing Theory and Practice, 3rd Edition, Volume 1, pp. 239, 240, has the following to say relative to the accrual of taxes:

> *Taxes.*— * * * The federal tax accrues as of December 31 or at the end

> of the fiscal year, just as surely as any other item.
>
> The balance sheet of a commercial enterprise, prior to the enactment of the federal excess profits and federal and state income and franchise tax laws, rarely included a liability for accrued taxes unless real estate was owned. Under the laws mentioned taxes are imposed upon the net profits of corporations. This tax must be paid even if a corporation is dissolved before the end of the year for which the tax is imposed. Since the tax is specifically based on the net profits of a particular period, although payable some months thereafter, the tax accrues throughout such specific period; consequently, if a net profit is disclosed upon the closing of the books, an adequate reserve should be provided therefor.

Montgomery, in discussing the changed condition brought about by the Revenue Act of 1916, states the following with reference to the accrual of income and the failure to also accrue taxes:

> Under a provision of the law of September 8, 1916, an individual or corporation keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect the true net income, may, subject to regulations made by the Commissioner of Internal Revenue, make returns upon the basis upon which the accounts are kept.
>
> In accordance with this authority T. D. 2433 was issued January 8, 1917 * * *. All taxes accruing during a fiscal year or calendar year [with exceptions] may now be deducted in the return for the period during which the taxes accrue.

> *Those individuals and corporations which create reserves for taxes, for the proportion actually accrued, and which represent a charge against the income accrued, do so only because they desire to have their books reflect actual income. Frequently the accrued tax has a direct relation to income returned as accrued but not collected; therefore, it is as just to deduct one as to tax the other.* [Italics ours.] [*Montgomery, Income Tax Procedure,* 1918, pp. 305 and 306. See also pp. 67, 68, 241, 299 of the same edition.]

Esquerre, Applied Theory of Accounts, pp. 299–301, has the following to say relative to the cash basis and the accrual basis:

> *The Cash Basis.*—It may be that the policy of a concern is to keep its books on the "cash basis"; that is to say, to consider as income earned only that which has been received in cash, and that, correspondingly, only expenses paid in cash constitute income disbursed. This policy has the great disadvantage of not being consistent. It rests upon the possibility that the right to receive income may be lost by the failure of the debtor to pay what he owes, and upon the impossibility of enforcing payment when such contingency occurs. But if the basis is correct, it should apply also to accounts receivable recorded as a result of sales on credit, since the amount charged to customers contains not only the cost of the goods sold to them, but, as well, the profit realized on the sales. It is obvious that if it is sound theory to ignore income until it is received it is also sound theory to ignore the profit on sales until the customers have paid the indebted-

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ness which contains those profits. Yet it is doubtful whether a single instance could be found where a business concern which claims to be on a cash basis is consistent enough to apply that basis to merchandise transactions.

The Accrual Basis.—Many concerns keep their books on the "accrual basis." This method applies the accounting principle that the primary connection between the net assets and the net income derived therefrom, is a matter of earnings and of expense incurred, and not one of income received in cash and expenses paid in cash. It takes cognizance of the fact that unless income is recorded when earned, losses due to the failure to collect that income can not appear on financial statements.

* * * * *

Leaving expenses and liabilities out of the question for the time being, the adoption of the accrual basis means that, at the end of every accounting period, all income which has been earned during that period must be recorded as an accrued asset which, while perhaps not collected at the time, *because it is not due,* may be collected at some future time. This, of course, necessitates the recording of an income which will be credited to the profit and loss of the period, whether or not the accrued asset which it represents fails of collection. Thus, if the last interest receivable on investments in bonds of other companies or in bonds and mortgages or in loans on collateral, was received December 1, and the accounting period ends December 31, there has been earned interest for one month, which is an asset of the investor, as well as it is his income for the month of December.

Holmes, Federal Income Tax, 1917, pp. 299–301, in speaking of the Revenue Act of 1916, states the following with reference to accruals and reserves to meet liabilities:

> *Accruals.*—Corporations which accrue on their books, monthly or at other stated periods, amounts sufficient to meet fixed annual or other charges, may deduct from their gross income the amount so accrued, providing such accruals approximate as nearly as possible the actual liabilities for which the accruals are made, and provided that in cases wherein deductions are made on the accrual basis, income from fixed and determinable sources accruing to the corporation is returned, for the purpose of the tax, on the same basis.
>
> *Reserves to meet liabilities.*—Where pursuant to the consistent practice of accounting of a corporation, or pursuant to the requirements of the Interstate Commerce Commission, or of any federal, state, or municipal supervising authority, corporations set up and maintain reserves to meet liabilities, *the amount of which, and the date of payment or maturity of which is not definitely determined or determinable at at the time the liability is incurred,* the amount credited to such reserves may be deducted, provided the amounts deductible on account of the reserves approximate as nearly as can be determined the actual amounts which experience has demonstrated will be necessary to discharge the liabilities incurred during the year, for the payment of which additions to the reserves are made. If it is found that the amount credited to any such reserve is in excess of the reasonable or probable needs for which

the reserve was created, the excess will be disallowed as a deduction and restored to income for the purpose of the tax. In no event will sinking funds or other reserves set up to meet additions, betterments, or other capital obligations be allowed as deductions. Reserves to meet losses contingent upon shrinkage in values, losses from bad debts, losses from capital investments, etc., are not allowed as deductions, since such losses are only deductible when definitely determined as a result of a closed or completed transaction and actually charged off. [Italics ours.]

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